Principles for Responsible Investment

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RI QUARTERLY

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HIGHLIGHTS FROM THE ACADEMIC NETWORK CONFERENCE AND PRI IN PERSON 2017

The PRI Academic Research programme aims to engage and inform signatories and responsible investment practitioners with academic research that analyses current thinking and future trends, provides practical recommendations and is thought-provoking.

Contact: academic@unpri.org

The RI Quarterly extracts the essentials and distils key findings from research in a clear and concise manner for investment professionals.

EDITOR: Elizabeth Mills is a freelance researcher, writer and editor, and has worked with the PRI since 2015. Previously, she held positions at IHS Global Insight and Control Risks. She has an MA in International Relations.

Follow the PRI Initiative on

INTRODUCTION

BACK

Welcome to this edition of RI Quarterly, where we focus on the Academic Network Conference and PRI in Person. We were delighted to hold our annual global conferences in Berlin, and just before the German general election. Indeed, at a time of heightened political and societal sensitivity, the debates that took place at the conferences were brought into sharp focus.

One such issue is economic inequality and migration. *Social cohesion and inclusive growth: the investment risks and opportunities* focuses on the geopolitical influences on investment decision-making, how and why they are material, and the role of investors. Social factors, the relationship with GDP growth and global trends are also under the microscope in *Long-term social issues drive economic growth, so why aren't investors behind the wheel?*

The PRI is delighted to commend the winners of the PRI Award for Outstanding Research. In the winning qualitative paper, Governing responsible business conduct through financial markets? The case of French socially responsible investing, Giamporcaro, Gond and O'Sullivan consider the role of successive French governments in shaping CSR behaviour both within and through the financial marketplace, and explain why and how the country's SRI market has grown so strongly. Food for thought for the wider European market.

The winning paper of the quantitative prize, *The sustainability footprint of institutional investors* is by Gibson Brandon and Kruger. The authors get to the heart of quantifying the portfolio-level sustainability of institutional investors and find that longer investment horizons (and even shorter term, quarterly) reaps risk-adjusted returns. They also investigate why institutional investors hold sustainability-oriented portfolio allocations.

Robertson, the author of the winning student paper, *Responsible investment requires a proxy voting system responsive to retail investors*, takes a historical approach. The paper notes that institutional investors have increasingly incorporated ESG issues into their proxy voting and corporate engagement, but at the same time retail investors have become increasingly disengaged in terms of proxy voting.

The future continues to be in our editorial line of vision in The future of RI: How and where will millennials invest? Millennials will change finance and the investment industry, but finance and investment needs to change for them. This is our central question and the PRI instigated a Call for Essays for Masters and PhD students under the age of 35 to consider: 1. The top three challenges and opportunities the investment industry has not focused on adequately; 2. How and where current investment practice needs to change to step up?; 3. How to design and tailor RI criteria? and, 4. How can RI be delivered? The debate between the two shortlisted students was truly remarkable. You can listen to the debate here. We're pleased to feature the winning essay, *Handle with care: The empowered millennial*.

What we do and how we do it – indeed how we construct our investment universe and incentivise behaviours – is the focus of *Beyond modern portfolio theory*. Risk and return being the guiding North Star has severe and wide-ranging consequences for investment and society. The PRI is issuing a Call for Papers on modern portfolio theory that seeks to understand the practical limitations of its application and provide a critique. The prize is £10,000.

This edition also shares early insights from our first Call for Research. Two projects were commissioned to examine the success factors, and the impact on corporate financial performance, of collaborative engagement on ESG issues on a global scale. *Local leads, backed by global scale: the drivers of successful engagement* and How *ESG engagement creates value: bringing the corporate perspective to the fore* provide a preview of the full reports that will be published in the coming months.

Finally, many thanks to all the authors that presented at the Academic Network Conference last month. The available papers and presentations can be accessed here. It was a pleasure to work with the University of Hamburg. We will be collaborating with the Haas School of Business, UC Berkeley and also UC Davis next year. I look forward to welcoming you in San Francisco for the Academic Network Conference 2018 on 11 September!

Katherine Ng
Head of Academic Research

LONG-TERM SOCIAL ISSUES DRIVE ECONOMIC GROWTH, SO WHY AREN'T INVESTORS BEHIND THE WHEEL?

BACK

Morgan Slebos, Senior Policy Analyst, PRI
Craig MacKenzie, Head of Strategic Asset Allocation Research, Aberdeen Asset Management

Long-term social issues – the 'S' in ESG – matter for investors. They are key factors determining both long-term GDP growth and the level of equilibrium of interest rates. The reality is that social factors are among the most material long-term drivers of returns.

Investors have rightly focused on identifying and addressing the impacts of social issues in the market through investor-company engagements. But this work needs to be coupled with investor attention to the underlying drivers that influence economic growth and ultimately social outcomes – labour productivity, workforce participation and demographic change.

A failure to address these underlying drivers is important for investors for two reasons:

- Slow growth and ultra-low interest rates are a recipe for low investment returns in the years ahead – particularly as equity and bond prices are at stretched levels. This will make it yet more challenging for investors to service their liabilities in the long term.
- Slow growth is also a threat to political stability. Stagnant median incomes and high levels of inequality fuel the rise of populist parties who may pursue incoherent economic policies that make a bad economic situation worse – particularly policies that restrict the global trade, capital and migration flows.

The good news is that, while these social trends are deep-seated, they are not set in stone. They may be shifted by effective action by governments and other actors. The PRI's work on a sustainable financial system is starting to look at the ways investors can support proactive policies to mitigate these risks to investment returns, financial system resilience and social outcomes.

ECONOMIC GROWTH: STUCK IN NEUTRAL?

In the long run, returns from equites and many other risk assets are driven by economic growth. Growth in corporate revenues and earnings are key drivers of equity returns. For equity markets as a whole, this is ultimately driven by growth in the economy.

Alongside equities, many investors also depend on returns from government and corporate bonds. Weak growth and the global savings glut mean that government bond yields today are near all-time historical lows. Low government bond returns have forced investors to search for yield elsewhere, compressing credit spreads are resulting in low expected returns from credit too.

Low expected returns in the world's largest equity and bonds will be a major challenge for long-term investors. Pension funds may struggle to achieve their funding ratios. Insurance company solvency is put at risk, and more generally investors will struggle to meet their objectives.

ECONOMIC INEQUALITY

Economic inequality is influenced by many factors. If technology means many middle-income jobs are automated, there could be even stronger divides in the labour market, with more income inequality. Technology is also turning more low-skilled jobs into self-employment with fewer protections for workers. Similarly, if the economy creates more winner-takes-all business models with high barriers to entry, then we may see the spoils concentrated in the hands of the lucky few.

But inequality is also a public policy choice. It results from taxation policy, public education policy and levels of investment in urban development. The kind of frustration that motivates some supporters of Brexit and President Trump could result in a realignment of policy priorities and a reversal of current trends. The economic policies prescribed by populists will not necessarily increase incomes. Policies such as drastically reducing immigration or walking away from free trade agreements may end up reducing growth in incomes even further.

CHANGING STRUCTURE OF SOCIETY

One of the most important factors underlying the sluggish growth outlook is the fact that much of the world is in the early stages of a major demographic transition. Ageing populations, an emerging middle class, falling fertility rates and a shift in working age are all contributing to a major demographic shift which could create slow economic growth.

Shifts in working-age population growth in East Asian, several major European countries, the UK and US are likely to either shrink the labour force or reduce growth more slowly than in the past. This will significantly reduce the rate of potential GDP growth.

Demographics are also a factor underlying today's ultra-low interest rates. Interest rates have been falling since the 1990s – well before the financial crisis and the era of unconventional monetary policy. Central banks believe that the cause of the long-run decline in interest rates is a global 'savings glut' that stems from demographic change and a growing imbalance resulting from an increase in savings by baby boomers and emerging middle classes, and a decreasing propensity to invest by companies and governments due to low growth expectations. The imbalance between savings and investment pulls down real interest rates.

Eventually, the savings glut will reverse, leading to higher interest rates. But this is not expected to occur for some time. This has led some commentators to posit that the world could be entering an era of secular stagnation – where the 'zero lower bound' for interest rates makes it difficult for central banks to stimulate the economy in a down-turn resulting in sluggish recoveries and increasing financial instability.

DEMOGRAPHIC TRENDS AREN'T DESTINY, BUT THEY ARE HARD TO CHANGE

There are some ways that countries can compensate for the economic impacts of demographic change – by allowing more immigration, increasing labour force participation and encouraging older people to remain in work.

Immigration is an important factor and a major reason why working age populations are forecast to continue to grow in the developed economies. However, tolerance for immigration can change. The recent electoral success of populist anti-immigration movements suggests that tolerance appears to be declining in many places and reducing the impact of immigration on labour force growth.

But younger people seem much more tolerant of immigration, so perhaps this opposition will not be permanent. As population pressures build in Africa and the effects of climate change start to be felt, there will be a pressing need to manage immigration more creatively.

Governments can also take steps to encourage higher rates of labour force participation – for example, by raising the age at which state benefits and pensions are paid. This can delay the effects of demographic change, though it is not always popular and political leaders are increasingly reluctant to alter the pension age due to fear of an electoral backlash. Governments can implement policies that support parents in the workplace – for example, by subsidising nursery places for the less well-off, more flexible parental leave and job-sharing schemes.

PRODUCTIVITY AND INNOVATION

The other major factor in driving slower growth is the very low levels of productivity growth in many developed economies. Productivity growth is currently running at less than 1% per year, vs over 2% in the decade before the financial crisis.

Some argue that low productivity is here to stay. In this view, rapid growth in productivity seen in the 20th century was exceptional, driven by dramatic improvement in educational

attainment in the workforce, and radical technological advances. Many of these changes could only happen once; subsequent changes are likely to be incremental resulting in lower productivity growth.

This might be too pessimistic: we may be on the cusp of a Second Machine Age or Fourth Industrial Revolution. Some commentators argue that machines can do almost anything human beings can. In their view, automation makes the world better and this era will be better for the simple reason that, thanks to digital technologies, we'll be able to produce more: more healthcare, more education, more entertainment, and more of all the other material goods and services we value.

Poor productivity also seems to result from several other factors. The IMF and OECD have identified the large gap between the most productive companies and the least as a particular area to address. This long tail of poor productivity can be explained by companies having failed to invest sufficiently in long-term competitiveness.

Perhaps more damning is the argument that companies have become too short-termist, with executives focusing too much on hitting the near-term targets that trigger their share option packages, rather than working for longer-term success. There may be other reasons for the troubling lack of dynamism in large parts of the corporate sector, a lack of competition in a 'winner takes all' economy; the persistence of highly indebted 'zombie' companies kept alive by very low interest rates; and the old and inadequate public infrastructure in many advanced economies.

Dealing with poor productivity
Faster productivity is likely to be the best hope of offsetting the economic growth implications of demographic changes. If we are unable to improve on today's dismal productivity growth, we will see very low levels of GDP growth, with negative consequences for incomes and investment returns, and political stability.

Technological progress is alive and well and we can expect periods of more rapid productivity growth across a range of business sectors in the future. When those benefits will appear at scale is an open question.

Robots cannot cure our productivity ills without steps being taken to resolve the other sources of our productivity malaise. There is much work to be done addressing the other causes of weak productivity growth – by addressing short-termism, encouraging corporate capital investment; addressing the weak diffusion of innovation across the economy; improving competitiveness; and investing more in public infrastructure.

EMERGING POLICY AGENDA

Addressing these issues is not an easy task, but there are a number of possible policy interventions that have already been suggested by bodies such as the IMF, OECD, World Bank and central banks.

These recommendations focus on current barriers to productivity growth and supporting workers disproportionately affected by economic disruption. Productivity growth is an essential policy lever because it is the most important source of higher income and rising living standards over the long term – it also should have direct benefits for equity investors in the form of higher corporate earnings.

In encouraging higher productivity growth, it will be important to minimise the impact of disruption on workers displaced by new technologies – for example, by ensuring there are effective retraining programmes. This will help ensure the stability of social, political, economic and financial systems.

Recommendations put forward to sustain productivity growth include:

- policies to foster diffusion of technology and reinforce trade openness and the international mobility of skilled workers;
- policy signals to encourage private investment and risk taking, particularly high-quality public investments in education and training, basic R&D, and infrastructure;
- removing unnecessary barriers to competition and providing tax incentives for R&D;
- reforms to policies that restrict worker mobility and amplify skills mismatch and funding for lifelong learning to combat slowing growth and rising inequality;
- retool income policies and tax systems to support lower skilled workers who suffer disproportionally from disruptive economic transition.

Investors can help this emerging policy agenda gain traction.

INVESTORS NEED TO GET IN THE DRIVER'S SEAT

There isn't a trade-off between addressing the big social issues and investor interests. In fact, the opposite is true; there are few things more beneficial to long-term investor returns than mitigating the risks arising from these long-term social trends.

In January, RI Quarterly explored inequality and how investors might address this issue. We profiled some of the tools that investors may use to inform investment decisions and determine shareholder engagement, such as economically-targeted investment products, microfinance, bottom of the pyramid strategies and blended finance. This is one useful step.

The most important step investors can take is to move away from the tendency to be passive on large scale social issues. Long-term investors like pension funds and insurance companies have a huge stake in the long-term future of the economy. CEOs and politicians are here today, gone tomorrow, but long-term institutional investors, and the beneficiaries who depend on them, have to live with the consequences of poor economic policy for decades to come.

We have an interest and a responsibility to use our influence to tackle the underlying barriers to more dynamic and sustainable long-term economic growth. This means addressing the social trends in demographics, productivity and inequality that put this growth at risk.

Investors can and already do play a role directly in fostering growth through the allocation of capital in support of long-term investment. But there are other important roles to play.

- PRI signatories represent US$29.5 trillion global equity ownership and can influence corporates through their active ownership. To reverse the effects of poor productivity growth, they engage with companies on poor corporate management structures and incentives, as well as the way in which the business is investing in its future development.
- Investors can work with policy makers to develop economic policies which drive faster, more sustainable growth, and mitigate the impact of the savings glut. This includes policies to improve productivity, reduce the extremes of inequality, and minimise the disruptive effects of necessary economic transformation. Ambitious new policies, such as those put forward by the OECD and the IMF, will need to be supported by investors.
- Infrastructure investment will be an important avenue to boost growth, reduce the savings glut and offer returns for investors. Public investment in infrastructure – in important source of productivity growth – has been on a long-term downward trend in developed economies for decades. Many economic policy makers have suggested the world embarks on a large-scale infrastructure investment to boost demand, capital investment and productivity – while also addressing issues such as climate change. Given that sensible infrastructure investment pays for itself, this should be a high priority.

As part of the PRI's work on a sustainable financial system, we are convening a group of investors to develop research on these policy issues and to explore ways that investors, companies and policy makers can address the structural social trends that undermine growth and long-term investment returns.

BEYOND MODERN PORTFOLIO THEORY – HOW INVESTORS CAN MITIGATE SYSTEMIC RISK THROUGH THE PORTFOLIO

BACK

James Hawley, Professor Emeritus School of Economics and Business, Saint Mary College of California, Head of Applied Research, TruValue Labs
Jon Lukomnik, Executive Director of the Investor Responsibility Research Center (IRRC)

Despite numerous academic studies demonstrating that the effect of market beta on an investor's portfolio dwarfs any returns achievable through security selection, few traditional investing styles attempt to influence beta. This is primarily because the near universally adopted modern portfolio theory (MPT) put forward by Nobel laureate Harry Markowitz in 1952 is blind to the effect of portfolio investment on the capital markets' overall risk/return profile and on the macro systems upon which the market relies for stability (the global financial, environmental and social systems). MPT doesn't account for investors' actions affecting systemic risk.

FROM UNINTENDED IMPACT…

In reality, however, normal investment activities' effects on systemic risk are many and manifest. Capital flows create risk-on/risk-off markets, for instance, and passive investment has become so popular (more than a third of the US stock market is now invested through some type of index fund) that it has begun to affect the marketplace, through the super portfolio effect.

The super portfolio effect means that simply being in a portfolio can affect the underlying securities. Super portfolios tend to herd, increasing systemic risk. This is a perfect example of how adherence to MPT drives certain types of portfolio investment, which then affects the beta of the market overall.

…THROUGH THE RISE OF THE INSTITUTIONAL INVESTOR…

But if portfolio investment can *unintentionally* affect systemic factors, can investors *intentionally* influence systemic risk factors, such as governance problems and climate change, so as to mitigate such risks?

SUPER PORTFOLIOS

Studies have shown securities changing price merely due to being included in an index, as well as the capital flows into or out of an index affecting prices of the securities within. The super portfolio effect sees the prices of the component securities in an index begin to move together, and float away from the other market participants, not because of individual security decisions, but merely because they are included in an index or other communally traded structure. The effect of indexation can even affect how the companies themselves operate: studies have revealed changes in everything from the structure of the Board of Directors and other governance areas to a reduction in research and development spending after a company is included in an index.

This type of action would seek to change not the price of an individual security (as with the more publicised type of 'shareholder activism'), but the nature of a market. That would suggest a path to both decreasing market risk and improving financial, environmental and social systems. We call this beta activism.

Before we examine it, let's ask a foundational question: if feedback loops between portfolio investment and systemic risk are possible, why were they not included in Markowitz's brilliant, original MPT theory? Why did he think alpha and beta were disjointed?

The answer is the rise of the institutional investor. To give an analogy: every individual on earth has a gravitational effect on the orbit of the moon, which varies as they move. However, it is immeasurably small, so has no meaningful effect, and there's so many other individuals that when you walk in one direction, someone else is inevitably walking in a different direction – so at a systemic level, they average out anyway. That, effectively, was Markowitz's world, where institutions only owned about 8% of the US equity market, and individuals' relatively small portfolios zigged and zagged in various directions, largely cancelling out any systemic impacts. Today, however, institutions own nearly 80% of the US equity market and a similar proportion of most others. Structural changes such as the rise of indexation, the creation of exchange-traded funds, and instantaneous communication combine to create super portfolios, as mentioned above. The sheer size of institutional portfolios makes manifest the feedback loops between the investments and the systems surrounding the financial markets.

> Markowitz's wonderful theory has become a victim of its own success: MPT has contributed to the rise of the concentration and institutionalisation of assets, and yet much of the practical implementation of MPT works well only as long as not too much of the market uses it.

...TO EXERTING DELIBERATE INFLUENCE: BETA ACTIVISM

Large investors, or groups of investors, can intentionally attempt – and often succeed – to mitigate systemic risks and affect beta. For example, political risk is considered external to portfolio investment: investors try to understand and price the risk, but generally do not try to change it.

Perhaps they should. In 2002, when the California Public Employees Retirement System (CalPERS) announced that they were divesting their holdings in the Philippines because of objections to how foreign investors were treated under Philippine law, the Philippine stock market fell 3.3% in a day and the Philippine government began negotiations with CalPERS. Two years later the laws were changed. In the real world, unlike in MPT theory, there are feedback loops between portfolio activity (disinvestment in this case) and the environmental, social and financial systems that create systemic risk.

Other examples include the New York City pension funds' proxy access campaign, which attempts to change the governance landscape of the US equity market by changing how directors may be nominated; Blackrock's efforts to get companies to focus the longer term; the Ceres coalition's focus on environmental issues; and the Investor Stewardship Group's goal of improving governance for the companies listed on US exchanges.

Beta activism has costs, borne by the beta activist but with the benefits accruing to all. This presents a free rider problem, where any given investor may be dissuaded from incurring costs to themselves in the hope that another will act for them. Institutional investors, however, have enough assets over which to spread the costs to be in a position where the absolute benefit to them can far outweigh the costs, mitigating the free rider effect.

BEYOND MODERN PORTFOLIO THEORY

These developments put in question a number of MPT's tenets, though those such as the ability to diversify idiosyncratic risk, continue to be central and relevant. While MPT remains enormously valuable, it is clear that many of the hallmarks of today's MPT-dominated investing need a fundamental rethink. Those who blindly seek alpha may find that the joke is on them. Changing beta holds far greater promise.

Aggregating assets across a coalition further mitigates the free rider problem. As the investors to whom it is individually beneficial to act do so, they improve the market for everyone.

THE PRI RESEARCH AWARDS

From left to right: Ian Robertson, Alexander Bassen, Martin Skancke, Jean-Pascal Gond and Katherine Ng

The international award recognised cutting edge research and the PRI is delighted to highlight the winning papers.

BEST QUALITATIVE PAPER

Governing responsible business conduct through financial markets? The case of French socially responsible investing

Stephanie Giamporcaro, Nottingham Trent Business School; Jean-Pascal Gond, Cass Business School; Niamh O'Sullivan, Nottingham University Business School

BEST QUANTITATIVE PAPER

The sustainability footprint of institutional investors

Rajna Nicole Gibson Brandon and Philipp Krueger, University of Geneva and Swiss Finance Institute

BEST STUDENT PAPER

Responsible investment requires a proxy voting system responsive to retail investors

Ian Robertson, University of Oxford

The full list of papers and presentations from the conference is available here.

The Academic Network Conference 2017 was a great success. Over 100 academics and practitioners convened as a community and discussed research across the breadth of responsible investment. We received around 70 submissions and each of these was peer reviewed by an academic and a practitioner, considering its contribution to RI research, the originality of its approach, methodological strength as well as the practical significance for investors. 28 papers were selected and it was great to see the audience engaging with the research findings! We look forward to building on this for the conference for next year in California.

As the newly elected Chair and Vice-chair of the Academic Network Advisory Committee with 15 academic and practitioners, we are also excited about the fantastic growth of the Academic Network to nearly 4,000 members! There is a great deal we can learn from each other.

To introduce ourselves: I am Alexander Bassen, Professor of Capital Markets and Management at the University of Hamburg. My work is at the academic, policy and industry levels. I am also a member of the German Council for Sustainable Development. My research primarily focuses on the measurement and the impact of sustainable behaviour on capital markets.

I'm Fabrizio Ferraro, Professor of Strategic Management at IESE, Business School in Barcelona. My research explores the emergence of responsible investing in the financial sector and aims to understand the evolution of different investment practices, with a special focus on shareholder engagement.

Look out for the Call for Papers for next year's conference – it will be coming out in early 2018.

Alexander Bassen
Professor of Finance, Chair for Capital Markets & Management, University of Hamburg

Fabrizio Ferraro
Professor of Strategic Management, IESE Business School

THE 2018 ACADEMIC CONFERENCE

The Berkeley-Haas Center for Responsible Business is honored to host the 2018 PRI Academic Network Conference in partnership with: the University of California, Berkeley, Haas School of Business Finance Group, working with Associate Professor of Finance, Adair Morse; and the University of California, Davis, Graduate School of Management, working with the Associate Dean and Professor of Finance, Brad Barber.

The Center for Responsible Business has long-standing leadership in responsible investing research, including the home of the prestigious Moskowitz SRI Research Prize, which will be presented for the 22nd time this fall. The Moskowitz Prize is the world's first global award recognising outstanding quantitative research in socially responsible investing.

Additionally, The Center for Responsible Business recently launched the Investment for Impact Research Prize, recognising outstanding research in the field of the social impact of capital. The inaugural prize will be awarded at our third-annual Berkeley Sustainable Business and Investment Forum in November 2017.

At the heart of both of these prizes is disseminating research findings across both the academic and practitioner communities – which aligns with the aims of the PRI's academic research activities.

These prizes and our forum are just a small part of our focus on sustainable investing and finance. We could not be more excited to partner in hosting the 2018 PRI Academic Network Conference - the first universities in the United States to do so.

The dean of the Haas Business School is honored to host and looks forward to have Haas play a leadership role in this important conference.

The call for papers for the Academic Network Conference will go out in early 2018. We look forward to seeing you on 11 September 2018 in San Francisco!

Seren Pendleton-Knoll
Associate Director - Center for Responsible Business, Haas School of Business, University of California, Berkeley

SAVE THE DATE

ACADEMIC NETWORK CONFERENCE 2018

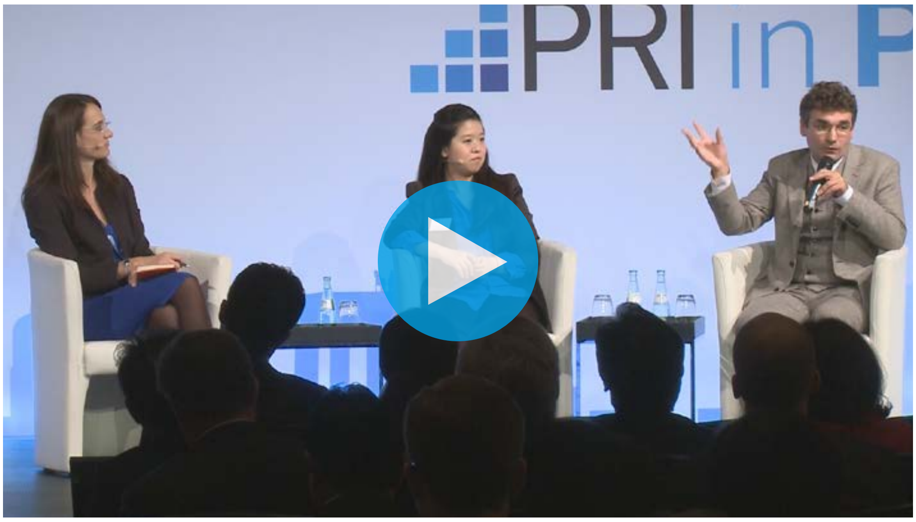
11 SEPTEMBER

Marriott Marquis, San Francisco

UNLOCKING THE VALUE OF SHAREHOLDER ENGAGEMENT AND COLLABORATION

BACK

Valeria Piani, Associate Director, ESG Engagements, PRI



As part of their commitment to implement the Principles for Responsible Investment, investors have been asked to consider ESG issues in their engagement policies and practices (Principle 2), and collaborate in their efforts to build a dialogue with investee companies (Principle 5) for more than a decade.

Shareholder engagement captures the interactions between investors and current or potential investee companies on ESG issues, with the goal of improving, or identifying the need to influence, ESG practices and/or improve ESG disclosure[1]. The underpinning belief is that shareholder engagement ensures sustainable value creation, benefitting shareholders and non-financial stakeholder groups. These interactions might be conducted individually or jointly with other investors.

Collaborative engagements include groups of investors working together, with or without the involvement of a formal investor network or other membership organisation. According to recent PRI data, engagement practices are becoming increasingly common among investors, with only 16% of signatories reporting they do not have any dialogue on ESG issues with listed equity companies in their portfolios[2]. Collaborative engagement is becoming common practice as shown by data from the PRI collaboration platform (a PRI private forum where investors can share information and pool resources to engage with companies). Over 600 PRI signatories have been involved in at least one collaborative initiative since the platform was launched in 2006, and over 1,100 collaborative proposals have been posted.

Academic research has provided some insight into the positive impact of shareholder engagement for company ESG practices and financial performance[3]. Research has also focused on elements of the engagement process that can help influence corporate behaviour[4], and crucial factors to foster successful collaborations[5].

Nonetheless, how shareholder engagement is adding knowledge and economic value to both investors and companies remains undiscovered.

There are also questions on the feasibility and effectiveness of collaborative engagements to influence corporate practices and increase financial returns.

This is why, in 2016, the PRI invited academic experts to investigate how coalitions of investors and companies can constructively and purposefully engage on ESG issues.

After a competitive selection process, two strong academic teams were selected to conduct complementary research following a qualitative and quantitative approach. The preliminary findings of these projects are encouraging and exclusive.

1 See PRI Reporting Framework definition
2 Data from the 2017 PRI Reporting Framework
3 Dimson et al., 2015; Becht et al., 2010; Junkin, 2015; Strickland et al., 1996; Wahal, 1996; Bauer et al., 2015; Clark and Hebb, 2004.
4 Gifford, 2010; Hebb, 2012; Ferraro and Beunza, 2013; Ferraro and Beunza, 2014; Rehbein et al., 2013
5 Gond and Piani, 2012; Guyatt, 2007; Guyatt, 2013; Thamotheran and Wildsmith, 2007

For the first time, quantitative academic research has been able to test the collaboration models delivering best results and demonstrate that successful collaborative engagements improve financial performance.

Equally, the qualitative analysis shows how shareholder engagement creates value through communicative, learning and political dynamics.

There is no doubt that shareholder collaborative engagement is adding value to both investors and companies.

LOCAL LEADS, BACKED BY GLOBAL SCALE: THE DRIVERS OF SUCCESSFUL ENGAGEMENT

BACK

Elroy Dimson, Cambridge Judge Business School, Oğuzhan Karakaş, Cambridge Judge Business School, and Xi Li, London School of Economics

One of the central tenets of responsible investment is engagement with investee companies. This is enshrined in the PRI's Principle 2, "We will be active owners and incorporate ESG issues into our ownership policies and practices," and it is practiced by more than 85% of PRI signatories with listed equity holdings. The PRI encourages and facilitates collaborative engagement, yet robust evidence of its effectiveness in driving corporate change and creating value for investors remains elusive.

Our detailed study, summarised here, provides the first detailed, global evidence of the impact of collaborative engagements. We find that successful engagements improve profitability at target companies, and we identify the key characteristics that lead engagements to be successful.

Our findings provide a business justification for investors to engage with investee companies, and suggest a model of the best way to go about it.

Table 1: PRI coordinated engagements by region 2007–2017

Geographic region	No. of dialogues	No. of targets	No. of countries
Developed Europe ex-UK	551	277	16
Emerging and Frontier	403	264	37
Other developed ex-US	314	193	8
US	291	163	1
UK	112	67	1
All regions	**1,671**	**964**	**63**

Table 2: Successful PRI coordinated engagements by broad theme 2007–2017

Engagement theme	No. of dialogues	No. of successful dialogues*	Mean (median) days till success*
Environmental	750	209	622 (610)
Social	176	85	1,122 (1,168)
Governance	75	63	1,069 (1,126)
UNGC reporting**	670	71	485 (393)
All themes	1,671	428	738 (730)

*Information on whether or not an engagement was successful is available for 1,016 of the 1,671 engagements.

**Engagements that address reporting on the application of the UN Global Compact principles.

The PRI coordinated 1,806 collaborative engagements between its launch in 2006 and the current time. Of these, 1,671 involved companies for which market capitalisation data is available in the fiscal year before engagement. Engagement is through a process of dialogue, defined as a sequence of interactions between an investor and a company on a specific issue.

Over the period covered by our sample, these dialogues involved 225 investment organisations (asset owners, investment managers and engagement service providers) from 24 countries, and 964 target companies from 63 countries (Table 1). The database also includes information on the strategy and success rates for each engagement. Success rates have been defined by PRI professionals based on a set of criteria and scorecards defined at the beginning of each project (Table 2).

EFFECTS AND CHARACTERISTICS OF SUCCESSFUL ENGAGEMENT

After engagements have concluded successfully, we find target companies experience improved profitability, as measured by return on assets, and increased ownership by the lead investor who conducted the dialogue on behalf of the coalition.

BACK

Unsuccessful engagements experience no change in return on assets or in shareholding.

Two key features make collaborative engagements more or less likely to succeed:

First, leadership is decisive. In collaborative engagements, success rates are elevated by about one-third when there is a lead investor heading the dialogue on behalf of the coalition, and success rates are particularly enhanced when that investor is headquartered in the same region as the target firm. For maximum effect, coordinated engagements on ESG issues should have a lead investor that is well suited linguistically, culturally and socially to influencing target companies.

Secondly, the scale of investor influence is important. Success rates are higher when participating investors are more numerous, when they own a bigger proportion of the target company and when they have more total assets under management. This is especially important when investors are engaging across national boundaries.

Supporting investors are crucial: they should ideally be major institutions that have influence because of their scale, ownership and geographic breadth.

WHICH COMPANIES GET TARGETED?

Engagements tend to be with the largest firms in their respective industry and country. These firms offer the biggest bang for the buck when investors are dedicating resources to active ownership. We compare each target firm with a control group of companies from the same country and industry, with as close a market capitalisation as possible.

Investors tend to target more mature and liquid firms, and those where there is higher institutional ownership, which can strengthen the power of the engagers' voice. Targeted companies tend to have lower stock-return volatility, higher profitability, and larger market capitalisation. Non-US companies are more likely to be targeted if their shares trade not only in their home market, but are made readily available to US investors through ADRs – American depositary receipts (Table 3).

PRI-coordinated engagements are heavily directed towards the manufacturing sector, followed by infrastructure, and wholesale and retail trade. Apart from agriculture, for which there are few initiatives, engagements in an industry group involve companies located in at least 12 and up to 52 different countries, depending on the industry (Table 4).

Table 3: Difference between target firm and matched control group in pre-engagement*

Firm characteristics	Average difference	t-statistic	No. of observations
ADR firm indicator	0.35	30.13	1,587
Shareholding of institutions	0.28	29.03	1,587
Shareholding of independent institutions	0.24	27.27	1,587
Shareholding of pension funds	0.04	25.32	1,587
Shareholding of mutual funds	0.06	22.24	1,587
Stock return volatility	-0.04	-22.13	1,563
Return on assets	0.08	16.68	1,584
Market capitalisation (US$ billion)	35.38	15.63	1,587

*Abbreviated table. Differences between targets and matched controls omitted when absolute value of the t-statistic is below 15.

Table 4: Successful PRI coordinated engagements by broad theme 2007–2017

Industry sector	No. of dialogues	No. of targets	No. of countries
Manufacturing	795	451	52
Infrastructure	231	141	35
Wholesale and retail trade	193	92	31
Mining	189	97	24
Financial	120	79	34
Services	73	61	21
Construction	34	24	12
Non-classifiable	34	17	13
Agriculture	2	2	2
All sectors	1,671	964	63

LESSONS FOR INVESTORS WORLDWIDE

Our earlier research, which can be viewed at www.tinyurl.com/ActiveOwn, analysed a major investor's engagements with US firms between 1999 and 2009. We found that dialogue involving a group of like-minded investors was instrumental in increasing the success rate of engagements on environmental and social (E&S) issues: after successful E&S engagements, companies experienced favourable stock market returns, better accounting performance, improved governance, and greater institutional ownership. That paper was the first to demonstrate the value of engagement, but did so only from a US viewpoint. Our new, innovative study expands the evidence to a global canvas, and turns attention to collaborative engagement as a crucial tool for responsible investors worldwide.

HOW ESG ENGAGEMENT CREATES VALUE: BRINGING THE CORPORATE PERSPECTIVE TO THE FORE

BACK

Professor Jean-Pascal Gond, Cass Business School

This article summaries some of the key findings of a research project led by Jean-Pascal Gond, with support from Rieneke Slager and Niamh O'Sullivan, Nottingham University Business School; Mikael Homanen and Szilvia Mosonyi, Cass Business School. A longer presentation of the main findings will be available in a PRI report at the end of the year, entitled How can ESG engagement create value for investors and corporations?

Corporate engagement on environmental, social and governance (ESG) issues is on the rise among investors. However, the mechanisms through which value is typically created have hitherto been an underexplored area, particularly from a corporate perspective. Our study addresses these blind spots.

Our global study, based on interviews and existing data,[1] considers the dynamics of engagement through both an investor and corporate lens (see table below). The findings also shed light on how each side perceives those engagement dynamics, including the barriers and enablers, as well as what success looks like.

Understanding these important differences is a crucial to improve the effectiveness of dialogue.

Exchanging information: Engagement creates communicative value as it improves information flow and understanding between corporations and investors. For example, it helps corporations develop a better sense of investors' expectations in relation to ESG issues, facilitating enhanced corporate accountability in this area. Engagement also offers unique opportunities for corporations to improve their image during a controversy or to promote aspects of their business model that may not be fully appreciated from the outside. Meanwhile, through engagement, investors can outline their ESG-related expectations from corporations as well as seek more detailed and accurate information about ESG practices and activities. In doing so, they can enhance their own ESG-related

Mechanisms of engagement value creation for corporations and investors

Value creation dynamics	Corporations	Investors
Exchanging information	▪ Clarifying expectations and enhancing accountability ▪ Managing impressions and rebalancing misrepresentations ▪ Specifying the business context	▪ Signalling and defining ESG expectations ▪ Seeking detailed and accurate corporate information ▪ Enhancing investor ESG communication & accountability
Producing and diffusing knowledge	▪ Anticipating and detecting new trends related to ESG ▪ Gathering feedback, benchmarking and gap-spotting ▪ Developing knowledge of ESG issues	▪ Building new ESG knowledge ▪ Contextualising investment decisions ▪ Identifying and diffusing industry best practice
Deriving political benefits	▪ Enrolling internal experts ▪ Elevating sustainability and securing resources ▪ Enhancing the loyalty of long-term investors	▪ Advancing internal collaboration and ESG integration ▪ Meeting client expectations ▪ Building long-term relationships

1 The findings are based on 37 interviews with 52 executives who manage investor ESG requests, as well as existing data about how investors manage engagement.

communication and accountability to clients, regulatory authorities and/or standard-setters.

Producing and diffusing knowledge: Engagement also has a "learning value", serving as a way to generate and share knowledge about ESG issues, future trends, as well as limitations of current practices and activities. Specialist ESG investors have helped some interviewees identify emerging ESG trends or learn how to showcase their ESG practices and activities to other investors. By enhancing their knowledge of ESG issues in the engagement process, investors can make more informed investment decisions in relation to a specific company and/or the relevant industry.

We found that corporations purposively use engagement to obtain feedback from investors about their ESG policies and practices, test how they are received, or benchmark their sustainability position against their industry peers.

Deriving political benefits: We also found that corporations and investors can gain political benefits by interacting with each other. On the corporate side, ESG-related requests from investors can help them develop internal relationships between operational and functional experts, raising board-level awareness of ESG issues and securing or enhancing resources for such activities. On the investor side, engagement is a way to more effectively show clients that investors are fully complying with their fiduciary duty to consider clients' interests.

INVESTOR-CORPORATE DISCONNECTS

By considering the corporate perspective, our study highlights important differences in corporate and investor perceptions of engagement dynamics, particularly regarding success.

For corporate actors, success can be defined across the following levels: communicative (e.g. responding to a request from an investor); learning (e.g. changing an investor's perception of the organisation); or behavioural/ instrumental (e.g. positive word-of-mouth from investors about ESG practices and activities). Similar levels are involved in investor definitions of success, albeit with distinct meanings, ranging, for example, from exercising client stewardship duties to leveraging ESG-related corporate behaviours to enhance financial performance.

Our comparative analysis also shows that investors and corporations have different views on the advantages and disadvantages of individual and collective forms of engagement. For example, engagements with single investors are viewed positively by corporations because numerous ESG issues can be covered, the caveat being they are time-consuming. In contrast, corporations see collective forms of engagement as cost-effective because they can meet several investors at once, which is particularly useful during the unfolding of a controversy. However, such engagements usually focus on one ESG issue and do not allow corporate actors to showcase their overall ESG practice and activities.

Finally, our analysis shows how corporations and investors view the distinct barriers and enablers to engagement. Although some of these barriers are relational and therefore common to corporations and investors (e.g. culture and language barriers that may prevent the development of a genuine dialogue), others are specific to each type of organisation (e.g. corporate bureaucracy, insufficient shareholding from investors to attract relevant corporate actors, or lack of resources to prepare for dialogue).

Our results suggest that improving ESG engagement may involve addressing multiple factors at the level of the investment firm, corporate investee, or the relational process that connects them both. Third-party organisations such as the PRI operating at the corporate-investor interface can play an important role in helping to enhance enablers while also diminishing the barriers to ESG engagement.

SOCIAL COHESION AND INCLUSIVE GROWTH: INVESTMENT RISKS AND OPPORTUNITIES

BACK

Social cohesion is an increasing concern in the investment sphere, skewing traditional notions and models. Three panellists: Helga Birgden, Partner at Mercer; David Wood, Director of the Initiative for Responsible Investment (IRI), Harvard Kennedy School; and Sustainability Strategist for Man Group, Jason Mitchell, took to the stage in a packed conference room at PRI in Person to discuss social cohesion and inclusive growth. Moderating the session was Georg Kell, Chairman of Arabesque Partners, who opened the discussion by asking how investors could and should react to today's global geopolitical challenges.

The panel's ideas were timely, coming just days after the German elections which saw Chancellor Angela Merkel and her centre-right Christian Democratic Union (CDU) party secure a fourth term. This was, however, at the expense of gains made by the far right Alternative for Germany (AFD) party, which took 12.6% of the popular vote, making it the third-largest party in parliament. Against this backdrop was Merkel's strong and positive stance on immigration, which has seen Germany take more refugees than any other EU country since 2014.

ECONOMIC INEQUALITY IS A PARADIGMATIC ISSUE TO THE "S" LIKE CLIMATE HAS BECOME TO "E" IN ESG

In a lively discussion, the panellists first looked at the issue of why economic inequality is important and how it affects investment and investors.

Wood, whose recent focus has been on researching social inequalities, began by challenging why investors should care about this topic. He argued that a key reason is because it has become politically salient, suggesting that the first obvious manifestation of this was Occupy Wall Street, which then-US president, Barack Obama, branded "the defining issue of our time."

> "Inequality is the measure of success of the financial system"

Research increasingly suggests inequality can harm growth, and excessive inequality is a burden on growth, which, in turn, is a burden on investment. Indeed, inequality can depress growth; Wood argued that this is because it depresses demand, meaning mass consumers have less money. He suggested it also potentially allows for rent-seeking and political capture, allowing people with the means to control the political system to keep these means, stifling innovation and economic change.

Wood has also been researching social cohesion, which new thinking suggests is essential to economic health. He cited the period since the US presidential elections and post-Brexit Britain as examples, highlighting that threats to social cohesion create economic problems. Economic inequality is an indicator that something is going wrong with societal cohesion.

Birgden, a leading expert on migration, focused on what issues such as involuntary migration mean for companies and how traditional investment thinking can – or in many cases, cannot – be applied to this type of social issue.

> "As investors, we are framed by our thinking. We need to build new ways of thinking about the economy and the investment process."

She revealed that investors largely disregard the issue of involuntary migration, even though it impacts business, government and policy. In her work, she follows four steps: she begins with investment beliefs, incorporates this into social system issues like migration, considers policy settings and asks whether they are capturing these wider issues. She then looks at the investment process and tests whether something like social migration is being incorporated into the portfolio.

This has prompted her to question traditional beliefs surrounding capitalism, which views it as a model that generates wealth, to the point where Birgden argues that capitalism is in fact spurring exponential inequalities.

INSTABILITY, DIMINISHING OPPORTUNITIES AND TRADE FLOWS

Mitchell brought a stark, first-hand perspective to this argument. He has spent the last two-and-a-half years covering the migrant crisis, travelling from Calais to Lesbos to northern Turkey, and most recently off the Libyan coast.

Eurosceptic parties, indeed the politics of populism, represent a destabilising force for national markets and beyond, and for financial markets. There is continued momentum behind far-right parties. But what does the inflow of migrants and refugees – and Mitchell underlined the fluidity of these terms – mean for markets? There will be market-positive stimulus, and he pointed to the example of Germany, where authorities have set the limit at two million refugees and committed to spending €12,000 per refugee, which he argued equated to roughly €30 billion of financial support. This translates into 15-20 basis points of GDP growth stimulus. However, integration takes time, a situation that is problematic in the face of growing questions from the electorate about these policies.

Mitchell also raised the important issue of moving beyond a European lens for the migrant crisis as there are significant implications for emerging markets. He questioned the extent to which the crisis represented diminishing opportunity, particularly in frontier markets of Sub-Saharan Africa. Emerging markets investors are keenly aware of understanding country, governance and sovereign debt risks, and consider institutional strength, transparency and accountability. Investors should be concerned by cuts in multilateral funding – for institution-building, for instance – as this will impact future migrant flows.

THE ROLE OF INVESTORS

The panel argued that while inequality is a structural issue, and that investors can't and shouldn't be responsible for fixing the political and economic issues that are driving this change, they are "on the hook because they caused a lot of this inequality."

In an attempt to redress the situation, considering ESG factors offers an answer. For Wood, economic inequality looks like a term that covers a lot of the "laundry list of topics in the S of ESG." He suggested investors needed to look at how they evaluate what they are investing in; for compensation, for the right to work, for the right to collective bargaining, and labour rights. These are all issues that allow investors to assess how a corporation or firm is contributing to inequality and potentially causing long-term instability.

Financial system failure is impacting policy, prompting investors to increasingly consider geopolitical issues. Investors are starting to ask for evidence in investment management processes for identifying social factors like human rights abuses and labour issues.

To address this sea change, Birgden argued that investors "need new lenses to sort these things out and we need to identify our blind spots." She called for geostrategic themes to be incorporated into macro-economic research and pointed to the need for new models. For her, "beliefs drive models...these need to change," with the story of disruption included in them.

In his summation, Kell highlighted the paradoxical nature of our world, which is increasingly inter-dependent while, at the same time, our collective ability to proactively tackle some issues is lacking, and multilateral systems are weakening. With this in mind, he suggested that investors had another key role to play – that of stewardship, including formulating their codes. He argued that this approach could be aligned with the work of the PRI and the UN's Sustainable Development Goals (SDGs) to amplify the underlining key messages.

THE FUTURE OF RI: HOW AND WHERE WILL MILLENNIALS INVEST?

BACK

Millennials are changing the nature of finance and how it works (or doesn't), corporations, the investment and pensions industry, and investment itself. Financial models and products must change to meet the needs and expectations of millennials, as well as the accompanying challenges and opportunities of the future. The PRI focused on this by issuing an essay competition for Masters and PhD students under the age of 35.

The essays address the following questions:

1. What are the top three challenges and opportunities the investment industry has not focused on adequately (or thought of yet)?
2. How and where does current investment practice need to change to overcome these barriers and step up?
3. How to design and tailor RI criteria?
4. How can responsible investing be delivered?

Two essays were shortlisted and the students presented their vision of the future to a panel composed of an asset owner, an investment manager and an investment consultant. The panel selected the winner based on factors including: likelihood, innovation and strength of impact. This article summarises the discussion and reveals the winning essay.

THE STUDENTS

- Laila Dib, MSc student, Maastricht University
  Responsible Investment in Millennial Times
- Mikael Homanen, PhD student, City University
  Handle with Care: The Empowered Millennial

THE PANELLISTS

- Dr Michael Viehs, Manager, Engagement, Hermes EOS and PRI Academic Network Advisory Committee member (moderator)
- Andreas Hallermeier, Head of Sustainability, Bayerische Versorgungskammer (BVK)
- Amanda Young, Head of Responsible Investment, Standard Life Investments
- Daniel Ingram, Vice-President of Responsible Investment Research and Consulting, Wilshire Associates

Millennials are attracting interest and apprehension in equal measure. What does the future hold and how can the investment industry address key challenges? Dib positioned her argument through the filter of gender, arguing that RI products for women or those that have a robust gender-specific component are almost non-existent. In a market where over half of investors are women, Dib underlined the short-sighted nature of this situation.

Homanen viewed the RI movement of the last 10 years as an "individual revolution," arguing that millennials are "very reactive when it comes to ESG factors. They want to contribute to the future that they want for themselves." He highlighted parallels between charities and ESG, saying the approaches should be similar with millennials seeking "real ESG products, not just a label."

Homanen warned that: "ESG can feel like a false promise for a lot of young investors."

On the first issue – the challenges and opportunities of RI – the pair were asked to debate, Dib quickly flagged up the issue of generational differences. Millennials "live entirely different lifestyles from their parents, often holding different sets of beliefs." The difference she highlighted as being of greatest relevance was the preference for almost any service to be available to them online.

Millennials "live entirely different lifestyles from their parents, often holding different sets of beliefs."

DISRUPTORS THAT WILL DRIVE INVESTMENT: THE ROLE OF TECHNOLOGY AND COMMUNICATION

This issue of technology resonated during question time. Young posited that "disruption is part of the millennial mantra." She asked the pair what they anticipate will be the biggest disrupter that will drive investment in the next 10 years.

Dib pointed to technology, which she views as a blessing and a curse. Although technology won't solve the issue of how to get people to invest sustainably, it is necessary for delivery and to increase access, she said, arguing that you "need to make it really simple." Homanen suggested there was a communication issue when "framing ESG products." He quoted Simon Howard, chief executive at UKSIF, who recently argued that any message or communication should be framed in 18 characters for millennials, which isn't possible for ESG issues. Homanen argued the situation will reach a point where ESG can be standardised, and that this will provide the necessary tipping point for change about how we communicate about ESG and ESG products.

Homanen also focused on the savvy and demanding nature of millennials, saying individuals "are demanding more 'bang for their buck' and they do not just mean financial returns anymore." He argued that the investment community is missing out on opportunities from three main developments, namely what he called the "individual revolution", as well as understanding ESG and communicating ESG. He warned that while the investment community is changing its products as a reaction to unexpected investor demand for ESG investments, this is only the beginning.

BUILDING TRUST

The pair went on to explain the second part of their respective papers – namely how, in the face of these challenges, the investment industry needs to step up. Trust and sincerity were their key messages. Dib stressed millennials' deep distrust of traditional financial institutions, which in her view extended to "traditional companies attempting to ride the green wave." She also argued that many millennials found investing confusing. Citing a Harris Poll from 2016, Dib highlighted that 69% of millennials surveyed, and 76% of female millennials, held this view. Homanen's plea to the investment community is to take issues seriously. He argued that millennials are "increasingly sensitive" to controversial news from financial institutions, making those institutions that are aligned with their interests a lot more attractive. Both these arguments point to the need to simplify products and host them on different platforms.

Trust was a buzzword during question time. Dib focused her argument on the need to "inspire trust and make it simpler and cleaner to invest" because, as she put it, "millennials are distrustful; they grew up with the financial crisis." A different side to this issue emerged when Ingram questioned why it is that millennials are willing to trust fintech platforms over traditional platforms.

"Millennials are distrustful; they grew up with the financial crisis."

Dib argued that it is a matter of blind trust, and that much of it is rooted in the fact that things have not yet gone wrong with these platforms. Echoing this, Homanen argued that those who have experienced financial crises are more risk averse, and that "millennials just haven't had these shocks yet."

HOW TO DESIGN AND TAILOR RI CRITERIA

For Dib, the responsibility to invest was shared. She argued that the investment community needed to facilitate investment, which, in turn, would leave no excuse for millennials not to be able to invest in line with their values. To facilitate investment, Dib suggested providing greater resources for those who invest to learn basic economics and finance. She also reiterated the issue of placing products online with the argument that investment companies shouldn't expect millennials to form relationships with banks and other institutions in the way that previous generations have. Finally, Dib argued the investment community must offer a range of products, providing enough of them and in a customisable form, to meet the demands of a large, but not homogenous marketplace.

Homanen stressed that more reliable information is needed. For him, millennials reject what he described as the "traditional 'check-box' mentality" in favour of qualitative assessments. Asset managers should "choose the ESG criteria relevant to the industries in question and communicate this directly with younger investors," he said.

Highlighting an important point on this issue, Hallermeier asked how you combine ESG if you have a generation that didn't want to invest in complex investments? Dib again suggested that this comes down to trust, saying: "People need to believe [in] what you are doing and where you put your money is good."

HOW TO DELIVER RESPONSIBLE INVESTING

These sentiments extended to the delivery of RI. Homanen encapsulated this in a single word, honesty. For him, motivation to invest mirrors how charities attract donations, arguing trust and honest delivery should be more prominent factors in the transaction. Similarly, Dib noted that if investment companies want to inspire trust and attract millennials, they need to be transparent in how they deliver their products. Specifically, the design of RI should move in the direction of the Sustainability Accounting Standards Board's Materiality Map. Beyond this, she argued the need for a basic global standard for tracking and reporting to simplify investor access to information.

During question time, the students were also asked to outline their thoughts on how to communicate to millennials about what the investment industry does, as financial awareness and education is crucial to engage. The pair had very different answers to this. For Homanen, it is important to deliver a simple message that underlines how a company is doing good with investors' money before going into greater detail as a next step. Meanwhile, Dib felt that messages should change to reflect location and culture, arguing that in her native country, Brazil, the word "sustainability" was well understood and has a significant, positive meaning. Elsewhere, it could have very different connotations or be less clearly defined.

At the end of the session in what was a very close contest, the panellists and moderator came down to an even split and the audience vote decided the winner. With 53% of the vote, Mikael Homenen was announced the winner, and it is with great pleasure that we feature his paper, *Handle with care: the empowered millennial*, in full.

HANDLE WITH CARE: THE EMPOWERED MILLENNIAL

BACK

Mikael Homanen, PhD Candidate, Faculty of Finance, Cass Business School

Here is the winning essay of a student competition issued by the PRI on the future of RI and millennials. Shortlisted articles were presented by the students at PRI in Person and you can read more about the debate here.

Millennials are more empowered than previous generations and they know what they want: to invest in the "future". During the past decade, the growth of forward-looking investments has increased tremendously. Socially-responsible investments are on the rise, green bond markets are expanding, ethical banks are growing and social impact bonds are entering the marketplace. The financial markets are transforming towards a future-oriented system fuelled by many factors, but especially, the younger generations (Morgan Stanley, 2017). This movement is growing and there are further opportunities to be utilised by those who realise and understand its true potential. However, handle with care, for this demand comes with previously unmet challenges for the investment community.

1) WHAT ARE THE TOP THREE CHALLENGES AND OPPORTUNITIES THE INVESTMENT INDUSTRY HAS NOT FOCUSED ON ADEQUATELY (OR THOUGHT OF YET)?

The recent decade has witnessed a growing attention towards environmental, social and governance (ESG) policies. It began with a focus on traditional companies and the concept of corporate social responsibility (CSR). Later, the investment community got involved with socially-responsible investments (SRI) and now the final developments are in the individual, in other words, the small investor. The small investor's growing investment demands have gone largely unnoticed and as a result the investment community has missed out on opportunities from three main developments: 1) the individual revolution 2) understanding ESG and 3) communicating ESG.

1) The individual revolution: Individuals are demanding more "bang for their buck" and they do not just mean financial returns anymore. The individual revolution has brought an increased focus on the individual consumer demand and, because of this, traditional corporations started continuously changing, adapting and tailoring their products. Along with these developments, corporations became increasingly accountable to their consumers, especially the millennials (Washington Post, 2011). Now, however, millennials have found a new target: finance. The era of specialised consumer demand has now begun in the financial sector and The Dakota Access Pipeline (DAPL) is an illustrative example of this phenomenon.

*The Dakota Access Pipeline protests were grassroots movements that began early in 2016 in reaction to an approved pipeline project in Northern US. The pipeline brought in a lot of controversy from environmental activists and Native Americans, because it was intended to cross both the Missouri and Mississippi Rivers as well as ancient burial grounds. By February 2017, 700,000 people had petitioned against their banks claiming that they were ready to withdraw over **$2.3 billion** if the banks did not stop financing the pipeline. By that time, thousands had already closed their accounts, removing over **$55 million** (Common Dreams, 2017).*

Since the DAPL incident, banks have taken a series of corrective measures and a few even sold their stakes in the project (ING, 2017). This example demonstrates that financial institutions and their operations are no longer immune to the preferences of their financiers, in other words, the savers.

Younger generations are demanding more from their banks, but banks are by far not the only ones to have been affected by these developments. The investment community is changing its product offerings as a reaction to unexpected investor demand for ESG investments and they need to understand that this is merely the beginning. So far, they have mainly witnessed the limited change of hearts found in the traditional investment communities, but as new generations are on their way, they will want their stocks, pensions, insurance and bank accounts all to make a difference. Some have anticipated these changes by offering ethical savings accounts (ING, 2017), green credit cards (Ålandsbanken, 2016), and there is even a new initiative by the UNFCC (United Nations Framework Convention on Climate Change) that offers individuals the chance to offset personal emissions by supporting environmental projects in developing countries. Paying €4.4 to offset 10 tonnes of personal CO_2 emissions can be a very attractive offer. Every financial institution needs to ask themselves; could I have attracted more investors if I had been aware of these changes?

2) Understanding ESG: In order for the investment community to start catering to the rising millennial investment demand, they need to understand the fundamental performance drivers of ESG factors. It is common to hear asset managers saying "we should invest in ESG, because it's good, everyone is doing it and the clients want it". Attitudes likes these are a partial explanation to the massive rise in passive ESG investment strategies (Harris, 2017). However, each component of ESG serves a different purpose and knowing this will be crucial in satisfying the millennial investor. Surprisingly, many of the younger investors believe that sustainable investing requires a financial trade-off (Morgan Stanley, 2017), therefore it will be important to rationalise why this is not the case. Energy efficiency

can bring production costs down, while better governance policies can create healthier corporate cultures. (Over) Investment in any realm can easily become unprofitable due to poor implementation or inadequate understanding. ESG is not a self-evident factor and an over-valued ESG factor serves no financial purpose. Attention to detail will be important for attracting the new generation of investors as they will be sure to ask: why and how is ESG good for financial returns?

3) Communicating ESG: Millennials are feeling financially empowered and they want real future-oriented investments, not just an ESG label. Once the investment community understands the fundamental values of ESG, they can start communicating it. The individual revolution is creating a growing demand for future-oriented investments and with it, they are requiring transparency and truth. The surge in ESG data providers (MSCI, Sustainalytics, Asset4ESG, etc.) are a reflection of this demand and there are increasingly more platforms (e.g. BankTrack, Tax Justice Network, Forest and Finance) that allow young investors to find out which financial institutions are taking these issues seriously. It is not uncommon to hear from young investors "I was about to invest in their ESG fund, until I later found out what stocks were actually in the portfolio". This is not a good start since millennials are among the most willing to pay for products and services considered social (Credit Suisse, 2017) and as much as 86% of millennial investor survey respondents said they were interested in sustainable investing (Morgan Stanley, 2017). The younger generations are demanding real change and the ESG tagline for many younger individuals can feel like a false promise. As the demand for information grows, the investment industry will need to learn how to communicate legitimate and realistic ESG investment policies to younger investors. If they do not, they run the risks of not attracting new young clients or potentially losing existing ones.

2) HOW AND WHERE DOES CURRENT INVESTMENT PRACTICE NEED TO CHANGE TO OVERCOME THESE "BARRIERS" AND STEP UP?

Take it seriously: To overcome current challenges and seize future opportunities, the investment community needs to take ESG strategies with all seriousness. Young investors and depositors are increasingly sensitive to controversial news from financial institutions and the DAPL example is no outlier. Panama Leaks created real reputational damage to the banking sector, and non-profit organisations are increasingly expanding their focus towards the larger financial community including pension funds, insurance companies and sovereign wealth funds (WWF, 2017). As information becomes more accessible and investor demand for "real" future investments increase, the investment community needs to understand that these efforts must be taken with vigour and determination. All of these recent developments are steering the millennial investor closer to the institutions aligned with their interests. Socially-responsible investing is not a side show anymore and those who tackle it without professional care will be likely to harm themselves in the long term.

3) HOW TO DESIGN AND TAILOR RI CRITERIA

Provide more reliable information: Responsible investment criteria are becoming more demanding as the traditional "check-box" mentality is regarded ill-fitting for understanding the real scope of ESG fundamentals. Simple ESG scores are not enough anymore as young investors want qualitative assessments for each component. If an average ESG score is 80%, but individual components range from 50%-95%, young investors will want to know about it. Asset managers must choose the ESG criteria that are relevant to the industries in question and communicate this directly to younger investors. Therefore, providing more reliable ESG information is the next step towards meeting the new millennial investment demand. Few asset managers have already identified this and are developing investment products that can directly communicate fund/ investment ESG ratings to their clients' phones. Other financial players, such as social banks, have relied on this source of "know where your money goes" communication for decades (Triodos, 2017). Others are following in their footsteps, but more remains to be done.

4) HOW CAN RESPONSIBLE INVESTING BE DELIVERED?

Be honest: Responsible investment cannot be implemented if it is not delivered honestly. If you are appealing to clients by their willingness to help and make the world a better place, you are taking advantage of the same set of inherent motivations that charitable institutions use to attract donations. This is not wrong in any way, but this makes trust a much larger factor in the investment transaction. Even the most well-intended and successful institutions, including micro-financing institutions such as KIVA, are not immune to criticism when lending or investment standards are deemed controversial (SF Weekly, 2008). In fact, they might be more likely to be criticised as expectations on them are set on a higher moral standard. This would change for the investment community as well. If young investors are to trust perceivable ESG ambitions, they must be genuine. Young investors are monitoring ESG performance at an increasing pace and even the most well-intended action can lose its credibility once people suspect ulterior motives.

The investment community is no longer drawing only on people's yearning for higher returns, hence they need to be careful with the promises and strategies they choose. Maximising the returns for investment and social impact is a completely different economic equation (Gneezy & Rustichini, 2000) and experience is not on our side. As we continue this path of combining two very different worlds of motivation, we need to handle our empowered millennial with care.

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

UN Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 9,500 companies and 3,000 non-business signatories based in over 160 countries, and more than 70 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact